

Fiscal Transparency and Beyond *

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It has always been an extremely productive venture for me to visit Indian Merchants Chamber and interact with the gathering. The subject chosen today has special relevance at this juncture for several reasons. The Reserve Bank of India (RBI) has released a Report on Fiscal Transparency a few weeks ago and it is necessary to view it and debate it in the context of fiscal challenges and their linkages with monetary policy. The Fiscal Responsibility and Budget Management Bill (FRB) currently under consideration has a special relevance to the overall policy relating to fiscal management. Further, the parameters for the Tenth Five Year Plan under contemplation in the Planning Commission do impinge on the fiscal issues.

In the first section of the presentation, there will be an overview of the fiscal transparency issues. It must be noted that the transparency issues are neutral to the substance and the content of the policy, though transparency is aimed at enhancing the quality and accountability of the policy. It will be clear that, while Indian standards are by and large upto international ones, some improvements are possible and most of these are envisaged in the proposed FRB. The second section elaborates on fiscal policy, narrating the various proposals under consideration at the central and state levels encompassing taxes, expenditures and public debt. It would be clear from the narration that there are several substantive issues that need to be addressed on an urgent basis, and almost all the proposals are well laid out. Indeed, a qualitative improvement in the fiscal management enhances the scope for transparency in policies, and both these aspects are addressed in FRB, as summarised in the third section. The fourth section elaborates the links between fiscal, monetary and financial transparency, in particular on management of public debt, where there is, understandably, convergence in the views of the Advisory Group on Fiscal Transparency; the Advisory Group on Transparency in Monetary and Financial Policies and FRB. The fifth section explores the extent of fiscal accountability to Parliament as per the provisions of the Constitution and attempts to establish that FRB supplements and enhances such accountability. The linkages between fiscal and monetary policies are discussed in conceptual terms in the penultimate section to establish that appropriate legal provisions and institutional structures such as those envisaged under FRB are only of enabling nature and the actual conduct of macro policies will have to address a complex set of issues. The concluding section emphasises the criticality of addressing the fiscal issues, and focuses on qualitative aspects in the medium term without which legislative changes and transparency practices will prove to be a burden rather than a benefit.

Fiscal Transparency

The Standing Committee on International Financial Standards and Codes was constituted in December 1999 to identify and monitor developments in global standards and codes, consider aspects of applicability of these standards to the Indian financial system, periodically review the status and make available its Reports to all concerned organisations in public or private sector. The Standing Committee in turn established ten separate Advisory Groups to look into existing Codes and standards in specific areas. One of these groups, viz., Advisory Group on Fiscal Transparency, under the chairmanship of Dr. Montek Singh Ahluwalia, submitted its Report to the Standing Committee in June 2001. The Report has been put on RBI website and is slated to be widely discussed, along with reports of other Groups.

The Group reviewed and analysed the transparency practices in relation to international standards in respect of various aspects of fiscal transparency. It has examined the extent to which fiscal practices in India comply with the International Monetary Fund's *Code of Good Practices on Fiscal Transparency*.

The IMF Manual on Fiscal Transparency provides four general principles of fiscal transparency, which form the basic structure of Code of Good Practices. These principles relate to (a) clarity of roles and responsibilities within government and between governments and the rest of the economy; (b) public availability of information on fiscal outcomes; (c) open and transparent budget preparation, execution and reporting; and (d) assurances of integrity, including those relating to the quality of fiscal data and the need for independent scrutiny of fiscal information.

The overall assessment of the Group is that current fiscal practices at the Central Government level satisfy the minimum requirements of the Code in many areas.

First, the roles and responsibilities of the central and state governments are well defined and there is a clear legal framework governing the management of the budget and extra-budgetary funds. The responsibility of fiscal management is clearly specified. The interface between the Government and the rest of the economy is governed by elaborate Constitutional and legal framework.

Second, although the division of expenditure and tax powers is complex, with areas of overlapping responsibility and multiple channels for resource transfers, the basic requirements of transparency are met.

Third, the requirement that management of public funds should ensure accountability is fully met. The ethical standards of behaviour for public servants are clear and well publicised with statutory laws relating to the behaviour of civil servants, and prescribed penalties for misconduct.

Fourth, Indian practice complies fully with international standards regarding public availability of information for the year for which the Budget is presented and also for preceding years.

Fifth, India subscribes to the Special Data Dissemination Standards (SDDS), and advance release calendar dates have been announced for release of data on central government operations. The aggregate budget outturns of the central government covering expenditure, revenues and fiscal deficit are publicly available on a monthly basis based on the information provided by the Controller General of Accounts (CGA).

Sixth, the institutional mechanisms for independent audit of fiscal data are very strong. The accounts of both the central government and the state governments are audited by the CAG, which has developed an enviable reputation for high standards of independent and strict scrutiny.

The Group, however, indicated that there are deficiencies in some important areas and the relevant observations are worth noting.

First, current budget practices could be improved if the basic principles of budget management are embodied in a general budget system law with Constitutional or near Constitutional status. Hence, the Group recommends that the scope of the FRB be amplified to include the essential

elements of a budget law, list macroeconomic assumptions regarding GDP growth, inflation, export and import growth, current account deficit, savings and investment rates, and project major categories of expenditure and revenue for two years ahead.

Second, since information provided on contingent liabilities, major tax expenditures and quasi-fiscal activities (QFAs), by both central government and state governments and also quantification of fiscal risks is inadequate, it recommends increased reporting of these elements, because ignoring these would understate the potential fiscal risk.

Third, given the scale of fiscal activity and the size of state level fiscal imbalances and other relevant extra-budgetary transactions, the group suggests provision of information on consolidated position of central and state governments, the overall public sector balance, as also on government equity in public sector enterprises and outstanding loans to these enterprises and the Oil Pool Account deficit.

Fourth, the simplification of the tax structure, with greater use of information technology, especially electronic filing, is called for in view of the complexity of the tax structure, especially the large number of exemptions, which create room for uncertainty and administrative discretion.

Fifth, from the central bank's perspective, the Group indicated that the most important deficiency relates to the prevalence of quasi-fiscal activities undertaken by the banking system and by non-financial public sector enterprises, which are not transparently identified and quantified. It notes that the RBI continues to provide direct support to government securities at the primary issue stage, in order to limit the impact of government borrowing on the market interest rate for government securities. It recommends the implementation of the FRB proposal, that the RBI end the practice of providing direct support to government securities at the primary issue stage by the end of 3 years *i.e.*, with effect from April 2004.

The overall assessment by the Group is: "To summarise, current fiscal practices at the central government level meet most of the minimum requirements of the Code and the gaps identified above could be closed in a relatively short time. We recommend that action should be taken as outlined above to close these gaps so that India can be said to be complying fully with the Code. The FRB contains many of the important initiatives need in this context". (The Group uses the acronym FRBMB for FRB).

In regard to fiscal practices at the state level, were felt to be generally behind the standards achieved at the central government level. Thus, the Group recommends that the Finance Secretaries Forum could review the *Report of the Advisory Group on Fiscal Transparency* and determine a set of minimum standards on transparency which all state governments should achieve within a three year period.

In brief, the Group focuses on provisions relating to Budget management in FRB as an adequate response to the need for enhancing fiscal transparency. It must be noted that the Group's recommendations are neutral to the actual content and conduct of fiscal policy.

Fiscal Policy

Transparency in fiscal operations implies openness towards public about structure and functions

of the Government, fiscal policy intention, public sector accounts and fiscal projection. Fiscal transparency is important because fiscal soundness is a core requirement for financial stability and transparency is needed for markets to be able to assess fiscal soundness accurately. However, there is a distinction between fiscal transparency and the other two ingredients of good fiscal management *viz.*, the soundness of public finances and the efficiency of fiscal policy instruments. The soundness of fiscal management relates to the macroeconomic issue of the fiscal balance, which is essential for stability. The efficiency of fiscal policy instruments relates to the microeconomic issues of the efficiency of particular expenditure programmes in achieving their objectives and the efficiency of tax policies in raising revenues with minimum economic distortion.

While the challenges of fiscal policy in India are well known, the measures envisaged to enhance the quality of fiscal management need to be debated, not merely at the time of the budget-presentation but on a more continuous basis, preferably in a medium term framework. It may be worthwhile to briefly recall the current thinking as enunciated by (a) strategy of Tenth Five Year Plan, (b) discussion paper on medium term fiscal strategy, (c) Report on Tax Policy and Tax Administration, (d) Reports on Expenditure Commission, (e) Report of Tax Reforms commission in Karnataka and (f) observations of Finance Commission on Public debt.

Tenth Five Year Plan (2002-2007) Strategy

The Macroeconomic parameters adopted for the Tenth Plan as set out in the Draft Approach Paper describes the baseline position and the Tenth Plan target. The base-line scenario is described as one emerging from current macroeconomic trends supplemented by the fiscal measures, which are already in the pipe line.

- (a) Average GDP growth rate per annum is expected to reach 8 per cent in the target scenario from 6.5 per cent in the base line scenario.
- (b) Gross investment rate is expected to increase to 32.6 per cent from 27.8 per cent in the base line.
- (c) Implicit incremental capital output ratio (ICOR) from 4.28 per cent in base line to improve to 4.08 per cent in the target scenario.
- (d) Current account deficit to increase from 1.5 per cent of GDP to 2.8 per cent of GDP in target scenario.
- (e) Gross domestic savings from 26.3 per cent in base line to increase to 29.8 per cent in target scenario with public sector savings ratio rising from 2.4 per cent of GDP to 4.6 per cent.
- (f) Within public sector, Government savings would show a turn around from negative 0.6 per cent to 1.7 per cent of GDP, while public enterprises would decline from 3 per cent to 2.9 per cent.
- (g) Private corporate sector savings to increase from 4.9 per cent to 5.8 per cent, while household sector savings would improve from 19.0 per cent to 19.4 per cent in the target scenario.

Consistent with these macro-parameters, the Tenth Plan approach paper presented a fiscal correction scenario for the Central Government needed to achieve GDP target. These are:

(a) Fiscal Deficit of the Centre is to reduce from 5.0 per cent during the Ninth Plan to 2.6 per cent of GDP in the Tenth Plan. The combined gross fiscal deficit of the Centre and States is targeted at 3.3 per cent during the Tenth Plan.

(b) Revenue Deficit of the Centre is to reduce from 3.4 per cent of GDP during Ninth Plan to 0.5 per cent in the Tenth Plan.

(c) Revenue receipts of the Centre is to grow from 9.1 per cent of GDP in the ninth Plan to 10.2 per cent in Tenth Plan.

(d) Revenue Expenditure is to reduce from 12.5 per cent of GDP in Ninth Plan to 10.7 per cent in the Tenth Plan.

(e) Total expenditure is to reduce from 15.4 per cent of GDP in the Ninth Plan to 14.0 per cent of GDP in the Tenth Plan.

(f) Non-Debt Capital receipt is to increase from 0.8 per cent of GDP in Ninth Plan to 1.2 per cent in the Tenth Plan.

The draft approach paper identified several decisions required to be made to achieve the fiscal correction needed at the Centre.

(i) Gross Budgetary Support for the Plan should be steadily increased as percentage of GDP to 5 per cent by the terminal year of the Plan, implying average annual growth of 18.3 per cent per annum.

(ii) Reduction in the number of government employees by 3 per cent per year with no new recruitment during the five year period. All additional requirements should be made through redeployment and rationalisation of various Ministries.

(iii) Non-Plan expenditure excluding interest payments, defence allocations and pay and allowances should be held constant in real terms to current level implying annual growth rate of 5 per cent.

(iv) Gross tax (including diesel cess) to GDP ratio rising from 9.16 per cent in 2001-02 to 11.7 per cent in 2006-07 implying a buoyancy of 1.44 per cent.

(v) Disinvestment process to be accelerated, yielding Rs.16,000 crore - Rs.17,000 crore per year on average over the first three years of the Tenth Plan.

(vi) Higher tax revenue should be achieved mainly through buoyancy and expansion of the tax base. Besides, a widespread and bold imposition of user charges of all non-merit goods.

It is obvious that fiscal corrections at the Centre and States are critical to reach even the modest targets for growth indicated in the approach paper and decisions needed are perhaps of a hard

nature.

Medium Term Fiscal Strategy

A Discussion Paper *viz.*, “India: Primary Aspects of a Medium Term Fiscal Strategy” prepared by Parthasarathi Shome in December 2000, highlighted major fiscal policy issues in India. Major observations of the Discussion Paper are:

First, on Centre’s tax reform, the Paper notes that while bringing down customs tariff rates to internationally comparable levels is a challenge, a greater challenge remains in terms of streamlining the exemptions. While there has been palpable progress in restructuring the central excise rate structure as well as in reducing distortions by minimising taxation of inputs, existing leakages from the tax base through exemptions pose a major problem. A major medium term challenge remains the coordination of central excises (CENVAT) with a state level VAT, with the objective of structuring a national VAT. Finally, it is imperative to introduce comprehensive taxation of services at the central level at the earliest. It should also be seriously considered for appropriate assignment at the levels of states and local bodies.

Second, on State’s tax reform, the Paper notes that some states are moving ahead with their own VAT reforms pertaining only to intra-state sales. These attempts are not as yet coordinated fully among states and may conflict with agreements on the floor rates of their sales tax regimes. It is important to address the issue of a state level VAT that includes interstate trade. This will obviously require close coordination among states and also with the Centre which should be facilitated by guidance from the Centre.

Third, on expenditure policy, the Paper recommends that in accordance with the Pay Commission and Expenditure Commission recommendations, the Ministry of Finance should propose a definitive strategy to reduce non-Plan expenditures. Its wage bill should be reduced through reduction in Government employment by a tenth as a first step, going upto a third in the final analysis in reflection of latest Expenditure Commission and Pay Commission recommendations.

Fourth, turning to subsidies, the Paper reiterates that subsidy reforms should be directed towards reduction in their size; making them of finite duration; using them for strict economic objectives; making them transparent; and administering them through final goods, with a view to maximising their reach towards the target population at minimum cost. Recovery rates, even for non-merit services are low. Most important, an increase in user charges in agriculture, irrigation, industries, power and transport would substantially mitigate pressures on the fiscal deficit.

Fifth, if public debt is to be amortised completely in 5-20 years, the Paper draws attention to the severe pressure on the primary balance-fiscal balance net of interest payments - that will ensue. Of course, if disinvestment in public enterprises progresses with some success, the proceeds could be utilised to amortise public debt. In the absence of any such indication, however, the debt sustainability simulations of the Paper do not assume any role of disinvestment proceeds in retiring public debt.

Finally, the performance of individual states in terms of their fiscal deficit to GDP ratios has not changed much over the past decade, with poor performers remaining below the better

performers. As per the Paper, this indicates that the Centre's revenue sharing and redistribution across states have not necessarily encouraged states to improve their performance.

Report of the Advisory Group on Tax Policy and Tax Administration

The Planning Commission constituted an Advisory Group under the Chairmanship of Prof. Parthasarathi Shome in July 2000 to study tax policy and tax administration issues and make appropriate recommendations at different levels of Government with the purpose of generating adequate resources for the Tenth Five Year Plan (2002-03 to 2006-07). The Group submitted its Final Report in May 2001.

The Group has made revenue projections for Tenth Plan period based on an overall growth in GDP of 15 per cent in nominal terms during the Tenth Plan period. The Group has observed that the Tax-GDP ratio of Centre and States has declined from 16.07 per cent of GDP in 1989-90 to 14.18 per cent in 1999-2000. Consistent with the GDP target, the Group has set in a target of Tax-GDP ratio of 17.78 per cent by the terminal year of 2006-07 from 14.09 per cent in 1999-2000. This would imply a 3.69 percentage point increase in Tax-GDP ratio. Of this increase, the Centre would have to achieve 2.08 percentage points of GDP and the States 1.61 percentage points of GDP through intensified tax revenue effort. In the case of Central Taxes, the Group assigns increase in terms of GDP in excise duties from 3.2 per cent to 3.5 per cent (+0.3 per cent), corporation tax 1.6 per cent to 2.4 per cent (+0.8 per cent) and personal income tax from 1.4 per cent to 1.9 per cent (+0.5 per cent). Service tax is projected to increase from 0.10 per cent of GDP in 1999-2000 to 0.57 per cent of GDP in 2006-07 (+0.47 per cent). At the State level, sales tax is projected to increase from 3.1 per cent of GDP to 4.1 per cent (+1.0 per cent), and State excise from 0.8 per cent to 1.0 per cent (+0.2 per cent).

Some of the major recommendations on Tax policy measures which have revenue implications are: (a) maximum marginal rate of personal income tax rate be retained at 30 per cent and retention of the existing three rate structure with modification in slabs; (b) the corporate tax rate not to exceed the maximum marginal personal income tax (30 per cent), coupled with abolition of the distribution tax on dividends and consequent reduction of the tax rate for foreign companies to the level recommended for domestic companies; (c) the 20 per cent dividend tax should be abolished, and instead, the Minimum Alternative Tax should be reconstituted as a tax equal to the aggregate of 0.75 per cent of adjusted net worth plus 10 per cent of the dividend distributed; (d) the income of the Funds should be subjected to tax at the lowest marginal rate of personal income tax, *i.e.*, at 10 per cent; (e) in respect of Union Excise Duty, a two-rate structure of 16 per cent together with a higher rate which should be introduced with an increasing number of items to be converged to fall under the 16 per cent rate to minimise classification problems. (The rates would have to be adjusted for inclusion of services in the CENVAT), (f) the median tariff rate in regard to Customs Duties should be brought down to 25 per cent in the 2002-03 budget since the objective should be to bring down the median tariff rate to 20 per cent in 2003-04 and 15 per cent in 2004-05.

The Group recommended that States should adopt a consumption type Value Added Tax (VAT) *i.e.*, there should be no distinction between raw materials and capital goods in allowing VAT credit. The consumption base must comprehensively include manufacturers and dealers of all goods indicated in sales tax schedules.

Further, the VAT on services should be fully integrated with the VAT on goods, both in its design and administration, with an appropriate mechanism to set-off service input tax against goods output tax and *vice versa*. A destination based, invoice credit method, dual VAT one at the Central level and another at the level of States comprising both goods and services could be envisaged by the end of the Tenth Plan.

Of particular reference to financial sector and conduct of monetary policy are the recommendations relating to elimination of tax incentives on savings. The Group suggests that tax incentives under Sections 80CC, 80, 80L and 10(15) of the Income Tax Act be abolished, at least in phases. Tax concessions under Sections 80D, 80DD, 80DDB and 80E are to be given in the form of tax credit rather than as deduction from income to improve equity. The rollover provision relating to capital gains under Section 54, 54B, 54D, 54EA and 54EB are sought to be removed. It may be noted that the Union Budget 2001-02 has already initiated measures in this direction.

The Group also suggested that provisions of Sections 10(8), 10(8A), 10(8B) and 10(9) be deleted, which provide exemption of foreign income and remuneration.

Expenditure Reforms Commission

The Government has set up an Expenditure Reforms Commission to improve expenditure management and to find solution to the process of downsizing of Government in a systematic way so that the role and administrative structure of the Government are reduced. The first report deals with food subsidy and the second report mainly dealt with rationalising fertiliser subsidy and optimising Government staff strength.

The Union Budget 2001-02 has effected some of the recommendations of the Expenditure Reforms Commission.

First, the Budget has proposed that instead of providing subsidised foodgrains, financial assistance will be provided to the State Governments to enable them to procure foodgrains to Below Poverty Line families at subsidised rates.

Second, Government has decided to implement the recommendations of the Expenditure Reforms Commission for a phased programme of complete decontrol of urea by April 1, 2006.

Third, downsizing in six Ministries will be implemented by July 31, 2001 and identified surplus staff transferred to the surplus pool.

Report of the Tax Reforms Commission in Karnataka

There are several aspects of fiscal stress at state level, which have been articulated, in the annual publication on State Finances brought out by RBI. Hence, in the current narration, only a latest report on tax reform at state level is described.

The Government of Karnataka as a part of efforts towards economic restructuring, set up the Tax Reforms Commission to (i) study the existing tax structure and tax collection procedures in Karnataka and (ii) to recommend measures for augmenting State's tax revenue by widening tax

base and preventing tax evasion.

The Report dealt with (i) extension of the tax base by increasing coverage and removing exemptions and concessions, (ii) rationalisation and reduction in tax slabs with an eye on the basic growth and equity objectives of each tax, (iii) tax rates (whether *ad valorem* or specific) and their effects on distribution of the tax burden and the incentive-disincentive structure for economic agents and consumers, and (iv) improvements required in governance to improve voluntary tax compliance as also to facilitate administration.

With regard to sales tax, the Commission has recommended elimination of exemptions and concessions, broadening of the tax base and simplification of tax structure. The Commission has suggested restructuring of sales tax rates by classifying commodities under three tax rates *viz.*, 4 per cent, 8 per cent and 12 per cent.

The Commission has recommended introduction of value added tax (VAT) at the

State level with a view to minimizing distortions and improving revenue productivity. To facilitate this, the Report has detailed sequential steps that are required to ensure smooth transition to the VAT by drawing a road map for adoption of VAT at State level.

The Report has also noted certain interState issues with regard to introduction of VAT. It is observed that given the floor rates agreed to by States, it would be difficult to design a VAT that is single rated or two rated by any particular State. Further, it would be necessary for the Centre to give up power to levy Sales Tax on certain commodities. Yet another issue relates to revenue loss for the State on account of VAT. The States are presumably expecting that the Centre will make up the revenue loss emanating from the process of change. There is a need to consider the issue of revenue compensation to losing states in a comprehensive manner. Otherwise, the process of VAT introduction in all States is likely to become less viable and it is certain to slow down.

The commission has recommended that a list of beneficiaries of tax exemptions and concessions above a limit should be placed before the legislature and the public as a part of the annual budget exercise. The Report recommends strengthening of the information system in the State by creating a database on major taxpayers and computerisation of the tax returns.

Eleventh Finance Commission's Observations on Public Debt

One of the terms of reference of the Eleventh Finance Commission (EFC) was to review the state of finances of the Union and the States and suggest ways and means whereby Governments, collectively and severally, may bring about a restructuring of public finances so as to restore budgetary balance and maintain macroeconomic stability. Regarding public debt, the major observations of the EFC were:

- First, the ratio of government debt (including external debt) to GDP is currently about 65 per cent. At the current level of indebtedness, over 40 per cent of the gross revenues of the Centre goes into interest payments alone. In case of States, interest payments constitute an

average about 22 per cent of the revenue receipts. If the public finances are to be restructured, the level of government debt should be brought down to a level that would help to contain interest payments to a reasonable proportion of revenue receipts so that adequate revenues are available for providing essential public services.

- Second, the growth of domestic debt of the Government had slowed down in the nineties following the fiscal corrections in the early years of the reforms with a narrowing of the wide gap between debt growth and nominal GDP growth that prevailed in the eighties (19.4 per cent as against 14.9 per cent). Yet, domestic debt growth continued to outpace growth in GDP in the nineties as well (15.2 per cent as against 12.5 per cent), pointing to the unsustainability of the fiscal deficit.
- Third, currently, the sustainability condition is violated in the budgets of the Centre, in the combined accounts of the Centre and States and individually in many States. Unless the present trends are reversed, and the deficits are brought down, the debt-GDP ratio will keep growing undermining the solvency of the public sector.
- Fourth, one of the basic structural weaknesses of the fiscal system is the ballooning of the pension liabilities of the public sector, a “ticking time bomb,” which may require some viable scheme of pension funding.
- Finally, from the angle of solvency and the likely impact of the high debt-GDP ratio on the economy and the Government budget, for the system as a whole, *i.e.*, Centre and States combined, the debt-GDP ratio needs to be reduced to around 55 per cent from its current level of 65 per cent. For this level to be attained and sustained, the proportion of interest payments to revenue receipts should not go beyond 25 per cent as against the current level of 35 per cent. This will further require raising the ratio of revenue receipts to GDP to 20 per cent. While for the Centre the desirable norm for interest payments would be 35 per cent of revenue receipts, for the States this ratio should be at about 18 per cent.

Fiscal Responsibility

The Government of India constituted the Committee on Fiscal Responsibility Legislation on January 17, 2000 to go into various aspects of the fiscal system and recommended a draft legislation on fiscal responsibility. This was followed by an announcement in the Budget 2000-01 for a strong institutional mechanism embodied in a “Fiscal Responsibility Act” and bring the necessary legislative proposals to the Parliament. Accordingly, the Fiscal Responsibility and Budget Management Bill, 2000 was introduced in Lok Sabha in December 2000.

The Bill envisages that the Central Government is to lay before both Houses of Parliament, along with the annual Budget in each financial year, three statements of fiscal policy, *viz.*, Medium-term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement. Further, the Central Government is required to take appropriate measures to eliminate the revenue deficit, bring down the fiscal deficit and build up adequate revenue surplus and in particular (a) reduce revenue deficit by an amount equivalent to one-half per cent, or

more of the estimated gross domestic product at the end of each financial year beginning on the 1st day of April 2001; (b) reduce revenue deficit to nil within a period of five financial years beginning from the initial financial year on the 1st day of April 2001 and ending on the 31st day of March 2006; (c) build up surplus amount of revenue and utilise such amount for discharging liabilities in excess of assets; (d) reduce fiscal deficit by an amount equivalent to one-half per cent or more of the estimated gross domestic product at the end of each financial year beginning on the 1st day of April; (e) reduce fiscal deficit for a financial year to not more than two per cent of the estimated gross domestic product for that year within a period of five financial years beginning from the initial financial year on the first day of April 2001 and ending on the 31st day of March 2006, and (f) not give guarantee for any amount exceeding one-half per cent of the estimated gross domestic product in any financial year.

Further, the Central Government has to ensure within a period of ten financial years, beginning from the initial financial year on the 1st day of April 2001, and ending on the 31st day of March 2011, that the total liabilities (including external debt at current exchange rate at the end of a financial year) do not exceed fifty per cent of the estimated gross domestic product for that year. There are provisions for relaxation from deficit reduction to deal with unforeseen demands on the finances of the Central Government on account of national security or natural calamities of national dimension.

Of particular relevance to the Reserve Bank is the prohibition of direct borrowings by the Central Government from the Reserve Bank of India after three years, except by way of advances to meet temporary cash needs under certain circumstances. It must be noted that this provision does not prohibit participation of the Reserve Bank in secondary market and does not eliminate monetisation. However, the scope for private placement of debt with RBI or devolvement of auctions of public debt on RBI is eliminated. In other words, the extent and terms of such monetisation would depend on the judgement of the Reserve Bank in regard to overall stability. Such operational freedom to RBI, whether enshrined in the FRB or not, is essential to assure the system that conduct of monetary policy balances the three relevant elements, namely, the fiscal needs of Government, the compulsion of deregulated interest rate regime and requirements of a more open external sector. In fact, separation of functions of a public debt manager from that of monetary authority should be viewed in this context.

Links between Fiscal, Monetary and Financial Transparency

In view of the linkage between fiscal and monetary policies, fiscal transparency should be accompanied by transparency in monetary and financial policies. Thus, the Advisory Group on Transparency in Monetary and Financial Policies (Chairman: Shri M. Narasimham) indicated an overall concept and context of transparency, evaluated India's compliance with international codes and made several recommendations.

First, in the context of their Report, the Advisory Group explained that transparency refers to an environment in which the objective of policy, its legal, institutional and economic framework, policy decisions and their rationale, data and information relating to monetary and financial policies and the specifics of accountability of different agencies are provided to the public in an unequivocal and understandable manner and accessible on a timely basis. Transparency should not be viewed as an end in itself, but a necessary prerequisite of good governance as policy

actions pass through the test of public scrutiny. The Advisory Group was of the view that greater transparency would compel the authorities to bring about a greater degree of rigour in the formulation of strategies and choice of instruments and there are distinct advantages in a well-informed public debate on the objectives and instruments. At the same time, the Advisory Group recognised that there may be good reason, for central banks not to disclose certain internal deliberations and documentation and near-term monetary and exchange rate policy implementation strategies. The authorities have to display considerable finesse while drawing the line on disclosures. The Advisory Group further observed that monetary policy is only an aspect of overall economic policy and, therefore, there is need for convergence in policies as also transparency in other aspects of economic policy.

Secondly, on the basis of a critical evaluation of India's compliance with International Codes, the Advisory Group noted that the RBI's policies and operations largely conform to the IMF Code, but there are clearly a number of areas where improvements need to be made before India can be said to be fully compliant with the IMF Code. In the area of dissemination of information and the rationale of policies, the RBI could be considered as being in accord with international best practices though there could be scope for further improvement, especially in providing precision to the monetary policy mandate and revealing of the process of monetary policy formulation. The Advisory Group recommends that the process of communicating the policy process, *albeit* on a *post facto* basis, needs to be institutionalised.

Thirdly, the Advisory Group recommended that the determination of interest rates should be exclusively a monetary policy function and that there should be well calibrated legislative measures to separate debt management and monetary policy functions. The Government should set up its own independent Debt Management Office to take over, in a phased manner, the present debt management functions discharged by the RBI. The Advisory Group recognised that separation of debt management and monetary policy is a necessary but not a sufficient condition for an effective monetary policy, which would also require a reasonable degree of fiscal responsibility.

Fourthly, the Advisory Group was of the view that what the RBI needs, by way of autonomy is headroom to operate monetary policy and this it would have once debt management is separated from monetary policy and the fisc is in reasonable balance. Over a phased period, as debt management is gradually distanced from monetary policy, the Government and RBI should progressively work towards greater clarity in publicly setting out the objectives of monetary policy. The RBI should evolve a move to greater transparency in setting out the process of monetary policy formulation so that accountability of the RBI can be properly assessed.

Fifthly, the Advisory Group made several other recommendations relating to desirability of single objective for monetary policy with inflation as the objective, setting up of a Monetary Policy Committee, disclosure requirements in respect of banks, financial institutions, supervisory authorities, regulators, *etc.*, but these have indirect linkage with fiscal transparency.

Of particular relevance is the fact that the Fiscal Transparency Group agrees that transparency requires that the RBI should not intervene in the primary issue of Government securities, but only in the secondary market where it can independently determine the trade-off between risking monetary expansion and tolerating high interest rates. It notes that the RBI as the debt manager is

responsible for the success of the Government securities issue, and is also allowed to pick up Government securities at the primary issue stage; thus, there is a conflict between this role and its role as the monetary authority. As a debt manager, the RBI wishes to minimise the cost of raising debt and is, therefore, often tempted to pick up substantial amounts of Government securities to avoid creating interest rate spikes. It notes that the FRB seeks to prohibit RBI support of Government securities in the primary market after 3 years, and views the same as a desirable step. It should be accompanied by the Government taking over the debt management function from the RBI as recommended by the Advisory Group on Transparency in Monetary and Financial Policies.

In this regard, it is gratifying to note that the Reserve Bank has made a formal announcement in favour of separation of debt management function in the statement on Monetary and Credit Policy of April 2001. As implied in the statement, such separation is predicated on a manageable level of fiscal deficit and Government borrowings.

In this context, it would be useful to critically examine the occasional suggestions in the media in favour of some special arrangements between the RBI and Government in order to reduce the growing interest burden on the Government. Essentially, such special arrangements imply write off of amounts due from Government or lending to Government by the RBI at interest rates that are not market-related. Basically, if a consolidated balance-sheet view of Government and the RBI is taken, it would make no difference, but precisely for that reason transparency may be preferred and the integrity of RBI having a separate balance sheet maintained. The case for transparency can be addressed on several grounds. First, at a philosophical level, authority to spend public money should be distinct from the authority to create money and their relations accounted for properly. Secondly, at a pragmatic level, the political horizon is short term and hence some authority with a longer term view should be juxtaposed. Thirdly, operationally, to enable a central bank to conduct Open Market Operations, especially in the context of external capital flows, there is need to have marketable securities. Fourthly, from a developmental perspective, development of debt markets requires that market for Government securities is well developed, particularly for financing of infrastructural needs. Finally, it is necessary to distinguish between market related operations in primary market, in secondary market and operations in non-market related securities. It can be argued, with some justification, that participation of RBI should continue in primary market as long as fiscal deficit is relatively high and financial-markets are not well developed. However, such a justification, as a transitional measure, will not be easy to advance in favour of non-market related interest rates to be charged by a central bank. In any case, there should be addition to profits that necessarily accrue as a result of market related rather than concessional rates. Thus, movement towards transparency in relations between RBI and Government in this regard proceeds in stages *viz.*, elimination of automatic monetisation; movement to market related interest rates in public debt; exit from primary market for Government debt; and finally removal of public debt function from RBI.

Fiscal Accountability

It is well recognised that transparency augments the scope for accountability in its broadest sense. However, in the context of Parliamentary system, the arrangements for accountability of fiscal management to Parliament gain significance. In fact, it can be argued that measures relating to fiscal transparency and fiscal responsibility explained so far complement and enhance

accountability, as enshrined in the Constitution of India.

Firstly, it must be noted that currently according to the Constitutional requirement, Parliamentary approval is needed for levying of taxes and incurring of expenditures. As per Article 112, the Annual Financial Statement (AFS) which corresponds to the popular conception of a Budget refers to estimated receipts with no distinction between current or capital; and estimated expenditure divided into charged and otherwise. In regard to the latter, however, a distinction is made between revenue expenditure and others. The AFS is not required to be approved by Parliament and as such the deviations also do not require Parliamentary ratification. No doubt, the object of presenting AFS is to provide transparency on Government account and it is essential that AFS provides a clear and unambiguous picture of the state of Government accounts. Since taxes require approval of Parliament and expenditure needs Parliamentary authorisation, it can be argued that AFS placed before Parliament for information is adequate to ensure accountability. In this context, the proposed Fiscal Responsibility Bill (FRB), by requiring the placement of medium-term fiscal framework *etc.*, before Parliament, partly addresses the issue of enhanced accountability.

Secondly, the Parliamentary control over incurring of Government debt, whether domestic or external is not explicit. Thus, to the extent that only demands for grants as per Article 113 and Appropriation Bill as per Article 114, as also supplementary grants as per Article 115 are approved by Parliament, all expenditures need to be authorised by Parliament. However, the entire debt servicing is charged as per Article 112(3)(c) and is thus not a subject matter of Parliamentary approval. In brief, and in practice, Parliament seems to have no role in formally approving the incurring of public debt or its servicing as per budgetary procedure set out in the Constitution, although there are separate provisions in the Constitution on the question of limits to borrowing only, on which Parliament has not yet legislated. The FRB seeks to address the issue of imposing some overall limits on incurring debt.

Thirdly, there are Constitutional provisions on public debt, some aspects of borrowing and guarantees. Debt is defined in Article 366 to include all liabilities to repay capital sums or liability under guarantee. Further, Article 112(3)(c) includes a reference to Sinking Fund charges also, but establishment of such a fund is not mandatory. Sinking Fund is not being operated now except by a few States. Most important, Article 292 provides for an enabling legislation by Parliament fixing limits on borrowing and issue of guarantees and Parliament has not passed any such legislation so far. In this connection, it is worth noting that the Article does not cover “other liabilities” which constitute debt but are not borrowings upon the security of the Consolidated Fund of India. FRB envisages a ceiling on debt which includes total liabilities, though not contingent liabilities. Thus the FRB covers some ground and in some ways goes beyond what Article 292 envisages.

Fiscal and Monetary Policy Linkages Issues and Coordination

In considering the issues of linkages between fiscal and monetary policies, it would be useful to clarify what constitutes fiscal policy and what monetary policy is about. As Mr. Premchand puts it, “Government action can be considered to be purely a fiscal policy matter only when the effect of borrowing is neutral in terms of the availability of money to the private sector. Pure fiscal policy is, however, rare, because any change in revenues and expenditures involves changes in

the financing of the budget surplus or deficit and, hence, always has an interface with monetary policy. Management of the debt - particularly, the composition of the instruments, the timing of their issue, and their duration - are aspects more closely associated with monetary policy”.

While in the academic literature, the optimal mix of monetary and fiscal policies has been analysed with respect to different exchange rate regimes, at an applied level, the relationship between fiscal and monetary policies may be analysed in the context of public debt, especially in terms of choice between bond financing and money financing of fiscal deficit.

Fiscal deficit, defined to be on cash basis for this discussion, can be financed either through bond issuance or money creation, and financing of the fiscal deficit may be non-voluntary or voluntary. Thus, a central bank may be obligated to extend credit to Government through what has been described as “automatic monetisation”. Similarly Government securities may be placed in captive market by legal stipulations, say on provident funds, insurance and banking.

Moreover, the financing of fiscal deficit may be at market determined or market related rates or at concessional rates, the latter being a by-product of non-voluntary financing. Arguably, captive market finances Government bonds at concessional rates, private sector may bear the burden; and when a central bank finances in a similar fashion, the Government as owner foregoes the revenue as profit transfer, except that “burden” is less transparent.

It must also be noted that while monetisation of Government deficit could provide primary liquidity to the market, liquidity creation could take place through other channels also, *viz.*, the central bank enlarging its holding of foreign currency assets; expanding its lending to the commercial sector, and conducting open market operations divested from the Government’s budgetary considerations. On the whole, the analytics of fiscal-monetary policy interface is thus not confined only to the quantum of monetisation of fiscal deficit, but extends to optimal financing mix for the fiscal deficit that stabilises inflation, interest rates and exchange rates at levels conducive for macroeconomic stability.

In the light of this broad framework, it would be useful to clarify three important issues relating to linkages at an operational level which are often debated and sometimes misunderstood.

First, there is no ideal level of fiscal deficit, and critical factors are : how is it financed and what is it used for? While the size of public debt is determined by fiscal policy, the composition of debt is decided by debt management policy. The monetary impact depends on who holds the debt and how the holding changes rather than by who initially issues or subscribes to the debt. The fiscal effect depends on the rate at which the size of debt is changing and the cost of servicing the debt. The monetary effect is determined by the effect of public debt on aggregate demand and level of interest rates.

Secondly, the actions of monetary authority also affect public debt in mainly two ways. The initial financial cost to Government of placing debt depends, to some extent, on the stance of monetary policy. The choice, design and operation of monetary policy instruments also impact the debt service costs. For example, liquidity of Government securities may be enhanced by monetary authority, through open market operations and reserve requirements.

Thirdly, the management of public debt affects the conduct of monetary policy, especially the

operational autonomy of the central bank in at least three different ways. The perceived sustainability of public debt often affects interest rates. The public debt management affects the demand for money. Above all, the management of public debt, in countries like India, plays a critical role in development of domestic financial markets and thus on the conduct of monetary policy, especially for its effective transmission.

In view of the complex nature of linkages, coordination between fiscal and monetary policies has to be considered from several angles. Since both are aspects of shared overall macroeconomic policy objectives, at the first level the question is whether the relevant fiscal-monetary policy mix is conducive to the macro objectives. The relevant policy mix relates to the level of fiscal deficit and the pattern of financing, especially the extent of monetisation and the flow of external savings.

Secondly, whether operating procedures of monetary and fiscal authorities, especially debt and cash management are consistent and mutually reinforcing.

Thirdly, whether credibility of both monetary and fiscal policies is achieved in a desirable direction. Thus, a credible monetary policy can help moderate interest rates provided the fiscal authority does not give rise to a different set of expectations.

Fourthly, whether due cognizance has been taken of the fact that monetary and fiscal policy adjustments operate in different timeframes.

Finally, harmonious implementation of policies may require that one policy is not unduly burdening the other for too long.

Conclusion

It should be clear that fiscal issues are wide-ranging and need to be approached from several angles, transparency being one of them. It is necessary to appreciate that transparency is no substitute for sound policy and their inter-relationship is somewhat complex. I had an occasion to briefly describe this link recently. "It is also possible to attempt a construct of the link between transparency and macroeconomic policy. Good macroeconomic policy and good standards is perhaps an ideal situation for a country. Good macroeconomic policy and poor transparency though not ideal is perhaps not risk by itself. Bad macroeconomic policy and good transparency has large elements of risk and warrants change in policy before launching into transparency. The most risky combination perhaps is bad macroeconomic policy and bad standards. In a more dynamic sense, it can be argued that transparency provides incentives to adopt good macroeconomic policies".

As regards the importance and indeed criticality of fiscal policy, Governor Jalan has articulated it in his recent Dr. C.D.Deshmukh Memorial Lecture : "At the same time, it is also clear that unless we put our fiscal house in order and improve our public delivery systems, no amount of macro-policy reforms by themselves will be sustainable or yield permanent results". Dr. Jalan adds : "Above all, we need fiscal empowerment as, without financial resources, it is not feasible to lay a road or build a school. The last is a most difficult task in view of the deadweight of the past, but it can no longer be avoided".

While considering the fiscal issues, it is not enough to consider quantities and ratios and in fact, quality of adjustment is indeed more important. This aspect was eloquently expressed in the Seventh Conference of State Finance Secretaries. They argued, that whenever fiscal adjustment is attempted, there is a cut in non-committed expenditure, but not in non-essential one. A predominant part of the budget is committed expenditure, especially interest, pensions and salaries, which have no flexibility. As a consequence, there is often an atrophy of delivery of services in as much as there may be hospitals manned by doctors and nurses but no medicines, electricity or water supply. Grants to several institutions performing vital services are often postponed or reduced on account of fiscal adjustment. They apprehend that cuts in output tend to be highly disproportional to cuts in expenditure making expenditure cuts of non-committed items highly unproductive, thus undermining the reform process.

Most important, some measures adopted for reducing fiscal deficit in one year could have the potential to understate the deficit in the short run and exacerbate the problem in the medium term. For example, tax exemptions in *lieu* of budgetary support for a limited period may give an impression of effort to reduce fiscal deficit but in reality could erode the anticipated tax revenues, thus defeating the purpose. In fact, the actual loss of revenue may turn out to be more than the expenditures that were necessary to serve the purpose. Time-bound offers of tax-concessions have yet another problem of making it difficult for concerned institutions/ activities to transit from tax-concessions to tax-payment. Similarly, intra public sector transactions to reduce the fiscal deficit without a change in overall public sector deficit can be misleading. Further, guarantees or letters of comfort may understate fiscal deficit at the current juncture, but may have the potential to worsen it in future years. The plea for transparency helps resolve these types of policy errors as well.

Finally, the related issues of transparency, policy, and institutional arrangements have to be assessed, not in abstract or in absolutes, but in the current context of budget systems, processes and practices as they operate now; levels of deficit and structural nature of deficits; patterns of expenditures, taxes as well as tax-concessions; returns on public investments; and finally, the maneuverability and flexibility needed for both fiscal and monetary authorities to ensure that outcomes are consistent with the intent.

* Address by Dr.Y.V.Reddy, Deputy Governor, Reserve Bank of India, to members of the Managing Committee of the Indian Merchants' Chamber at Mumbai on July 17, 2001.
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